WILLKIE FARR & GALLAGHER LLP **MEMORANDUM**

TO: Files

CC: The Audit Committee

FROM: Willkie Farr & Gallagher LLP

RE: Interview of Ronald Blair, September 27, 2005

DATED: October 28, 2005

On September 27, 2005, Michael Schachter and Sharon Blaskey interviewed Ronald R. Blair at the State Water Resources Control Board ("SWRCB") offices in Sacramento, California. Also in attendance for the early portion of the interview was Kathryn Bare of the SWRCB, who has taken over some of Blair's responsibilities since his retirement. Schachter began the interview with an overview of Willkie Farr & Gallagher LLP's ("Willkie") representation of the Audit Committee of the City of San Diego (the "City"), and the Committee's investigation into issues potentially affecting the City's financial reporting. Since Blair is neither a current nor former employee of the City, the standard warnings that we do not represent him were not given, however he was generally cautioned to be careful and truthful in answering the questions.

The following memorandum reflects my thoughts, impressions and opinions regarding our meeting with Ronald Blair, and constitutes protected work product. It is not nor is it intended to be a transcript of the interview.

Background/Experience

The SWRCB is a State agency that is responsible for most water quality issues. Blair retired from the SWRCB in June 2004 and is now a retired annuitant. In this capacity, he reviews statewide rate programs (not revenue programs). He started with the SWRCB in 1975 and remained there until his retirement in 2004. Blair first became involved with the revenue program in 1991. The revenue program began with the Environmental Protection Agency's ("EPA") Clean Water Grant Program in 1972 and continued through the mid-1980's. In the mid-1980's, Congress substituted the grants for a revolving loan program, providing low-interest loans to cities. The State drafted revenue program guidelines for these low-interest loans, and the EPA signed off on them. At the time of conversion from a grant to a loan program, the State was required to ensure that all users were being charged proportionate to their use.

Prior to Blair becoming involved in the revenue program in 1991, he computerized a "priority list" that would determine who would get federal grants. Once the computerization was complete, he became a construction coordinator, offering assistance in connection with wastewater plant construction. This background was useful when he began to work in the revenue program area because he was familiar with how much money was necessary for completion of wastewater projects. The two main criteria for the revenue program were (1) to distribute enough money to make sure the project operated properly, and (2) to make sure all

users paid their fair share. When he transitioned to the revenue program, he worked with his predecessor, Frank Peters, for three months before Peters retired.

Blair was shown Exhibit 1, the 1983 Revenue Program Guidelines (EA 2290), and described these guidelines as the last official "grant" program guidelines prior to the switch to the "loan" program guidelines. He did not draft them, but used them to draft the loan revenue program guidelines. He described them as "one size fits all" guidelines, meaning they apply to all agencies from the smallest to the most advanced.

Blair defined the following terms:

- **Primary treatment facility**: Treatment that only removes the most easily removable "stuff" from sewage. It is skimmed, and the "stuff" is scraped off, and the balance of what remains is what is disposed of. This type of treatment is very uncommon now. It does nothing for removing "organic materials" (i.e. anything that is not mineral, but is animal or vegetable). The primary treatment takes care of the "obviously objectionable stuff" (i.e. the "floatables") but does nothing to make the waste healthy for the environment.

- **Advanced primary treatment**: Portion of waste get secondary treatment, and all get primary treatment.

- **Secondary treatment**: treatment that includes primary **and** an organics component. After the primary treatment, the waste is subject to an organic process (injecting oxygen into the water to use the microbes to digest the "stuff"). Removes approximately 70-80% of the organics.

- **Tertiary treatment**: Treatment that approaches removal of 100% of organic material. It includes additional processes and good filtration that renders the water clean enough for re-use for limited purposes (i.e. irrigation), but not for drinking.

- **COD ("Chemical Oxygen Demand")**: Measurement of demand for oxygen in a sample by measuring the change in dissolved oxygen.

- **BOD ("Biological Oxygen Demand")**: More controlled test than test for COD, requiring refrigeration of a sample. Is more time consuming, more expensive, and more prone to error than COD.

- **TSS ("Total Suspended Solids")**: Very fine material that does not readily settle. The material is suspended in liquids, but will eventually settle if it sits long enough.

- **Participating Agencies (PA's)**: San Diego owns and operates treatment plants and has granted rights to others to use its plants. PA's are those municipalities outside San Diego that use San Diego's plants.

- **"Strength" of waste:** Refers to any matter in water other than water. Includes SS, COD, and BOD.

- **Septage**: "Stuff" that accumulates at the bottom of a septic tank that has a very high strength.

Blair characterized San Diego's Point Loma plant as a primary treatment environment. He elaborated that its outflow goes to the ocean and therefore different standards apply than if it were to flow inland. He described that the regional board issues permits that require the removal of certain percentages of waste parameters. The Point Loma permit limits the amount of SS and BOD/COD that can be passed on to the ocean.

The Clean Water Grant contracts contain "Fair and Equitable" guidelines (Exhibit 1 at Appendix B), which are included in the contracts at the "acknowledgement of," but not at the "demand of" the EPA. They constitute a separate state requirement. The purpose of these guidelines is to prevent the overcharging of the PA's. The guidelines prevent San Diego (and other municipalities) from raising the rates of the PA's (on the basis of PA status alone) to benefit its own retail users. To allow such overcharging would effectively allow cities to use federal and state funds to "penalize" PA's simply for living outside of the City's borders, since those facilities have been built using federal and state funds. In Exhibit 1, at EA 02315, is a list of criteria for cities to use in charging their PA's. These guidelines are not relevant to cities setting rates for their own retail users. A city follows the revenue program guidelines in setting the rates of its own users.

According to Blair, under the 1983 Revenue Program Guidelines (Exhibit 1), if there were a small city with no industrial users, it would be proper for that city to charge for flow and SS only (where there are only primary plants). However, as soon as there is an identifiable cost for organics removal (i.e. for larger or industrial dischargers), that cost must be allocated out. In Exhibit 1, at EA 02298, the guidelines direct cities to identify who is contributing to waste and what they are contributing. Specifically, the guidelines state, "Flows and loadings (BOD-5, SS or other appropriate constituents) must be documented for the user groups listed below, so that proportional costs can be calculated. Blair says that implicit in this requirement is that these components should be documented, "*as appropriate.*" As previously described, there are instances where, i.e. it would not be appropriate to measure organics in the absence of any allocable cost to organics removal. Blair said that the purpose is the same as with the federal regulations, which direct the measurement of components "such as" certain listed ones, so that, similarly, the components should only be measured (and hence charged for) where appropriate.

Exhibit 2 (SWRCB 2411) is the SRF Revenue Program Guidelines (dated May 10, 1988). At page 5, § 1.4 delineates the "Allocation of Annual Revenue Requirements and Rate Determination." The section states that, "Allocation of costs is done in two stages. First, the cost is allocated among the treatment parameters (flow, BOD, SS, and other appropriate constituents). Second, these amounts are divided by either total annual plant loadings. . ." Blair thinks that in 1990, at the time San Diego's program was reviewed by the State, the State's assumption was that there was no percentage of cost attributable to BOD/COD removal. He thinks that, at that time, the State was not completely aware how the City was meeting its permit requirements to remove a low percentage of BOD. The rationale behind the assumption is that primary plants are not typically removing organics.

When Blair visited the City in 1994 (as he later detailed), for the first time he saw the Point Loma permit, and saw that the permit had a BOD requirement. He asked how the City was meeting the BOD parameter, and he was told that in removing SS, enough BOD attached to it (since there is a tie-in between the two parameters) that they were able to meet the requirement. Blair was told that, on occasion, if removing the required amounts of SS did not get them to the acceptable limits, then they would remove even more SS (over and above that required by the permit), which had the effect of getting rid of more organics. When Blair learned that the City was spending additional money on SS removal to satisfy the organics requirement of the permit, he thought that, at a minimum, the City should track and charge for the allocable costs of organic removal (the difference between what the City would have otherwise spent on SS to meet the minimum permit requirements, and the excess amount they spent in removing additional SS to meet the organics requirements).

As of 1989 or 1990, the EPA required that PA's get approval of their own revenue plans. Therefore, PA's had to submit their revenue programs in order for Blair's predecessor, Peters, to give final approval of San Diego's own plan. Some of the PA's submitted plans based on flow, SS and COD, while others did not include COD. Blair said that one PA would not know what another's agreement with the City contained. When Peters retired, he told Blair that the only thing missing from San Diego's revenue plan was that its PA, Chula Vista, needed to submit a revenue plan. Peters said that once Chula Vista submitted it, then Blair could approve San Diego's plan that had been pending approval for a year or two at that time. Exhibit 3 (DK 03941), a letter from Blair to Charles Yackley, conveys that Chula Vista recently got approval of its plan, and all other PA's had approval, so "Congratulations, the City of San Diego has complied with all the appropriate revenue program requirements applicable to the above referenced projects." In Blair's mind, from the time he sent this letter, he thought San Diego was a "closed book."

Blair recalls that in 1994 he got a call from a consultant from the PA, Del Mar, and Del Mar was claiming that it did not want to charge its users for COD when the City was not. This phone call served as the impetus for Blair's trip to San Diego in 1994. It was during that visit that he learned that the City had no agreement for services with PA's, and Blair told them to negotiate it. It was also at that time that Blair told the City that all PA's must be charged on the same basis as if they were an industrial customer of the City. It was during that visit that Blair visited Point Loma and learned of the organics requirement in the permit, as described above. He thinks he had the conversation about the permit requirement with an assistant supervisor (either a number one or number two guy). This is when Blair concluded that since the City was spending more money to remove organics, the rates should reflect the costs. His understanding of how he left things with the City in 1994 was that the rates must incorporate an organics component, and that such an agreement must be codified with the PA's.

Exhibit 4 (DK 05453) is a letter dated September 30, 1994 from Blair to McGrory. In the letter Blair writes, "The City must modify their agreements with all participating agencies to include charges for BOD and TSS content as well as flow discharged into the facilities." While Blair acknowledges today that he only references agreements with PA's in that letter, and not all users, he states that in his mind he was thinking he had told the City to incorporate an organics component for *everyone* (not just the PA's). Blair said that once the City made the changes as to the PA's, he "blessed" the agreements, and once again he believed San Diego was "a closed book." Blair acknowledges in retrospect that he should have

asked for a City ordinance adopting new rates. He also plainly acknowledges that, while he told the City to implement the new rate structure for PA's (and not for everyone), he meant for the City to adopt it for everyone.

In about 1998 or 1999, Blair recalls that he started getting calls from David McKinley of Kelco, and based on those calls, today he assumes that someone must have been of the mindset in the City that an organics component was necessary. At this time, the City also had other plants. The first calls from McKinley were not too long after Blair approved the City's PA agreements, so Blair thought that the City was moving forward in a timely manner. Of Kelco, Blair explained that its process relied on cooking kelp (or seaweed). That process created a soluble by-product. Blair guesses that Kelco's process was a batch process (discharging large volumes at certain times and not at other times), which could explain why there were specific times that the normal SS removal at Point Loma removed sufficient amounts of organics, and at other times it did not.

According to Blair, it was not until the Fall of 2003 when he got a call from the City (Dennis Kahlie, who "wanted to see this thing done") that Blair learned that the City was still not in compliance. He understood from Kahlie during that call that someone in the City Attorney's Office took the position that if the State was not officially giving the City a deadline to do something, nothing would be done. Kahlie wanted to see the rates implemented: he had just finished the second study indicating what the rates should be, and he felt that the stakeholders group was being used to "stonewall" the whole process. Blair recalls Kahlie saying he did not think the City would do anything without a letter from Blair. So in response, Blair wrote a letter in the Fall of 2003, in which he asked the City whether the rates had been implemented. That letter then led to his later letter that the change needed to be done by June, 2004.

Referring back to Exhibit 4 (09/30/94 letter), Schachter called Blair's attention to item number 3 that stated, "Please provide the rational[e] for charging 'outside city' direct billed accounts twice the normal rate for sewer service. Under USEPA regulations the City must charge all users in proportion to the cost of providing treatment services." When asked whether this item could be read to mean that the rates should be changed for all users, Blair said no, this was a different issue about rates for those PA's directly outside the City, which issue Blair recalls the City addressing. At DK 05454, paragraph C, Blair again said this paragraph was addressing cost development for PA's (not the City itself). While Blair did say that the letter "was enough for City staff to know what they should have done," when he looked back at it in 2003, he did not feel that the letter was clear enough to tell the City it had violated it. He believed the intent of the letter was clear, that City staff knew what needed to be done, and that the City even commissioned studies to do it. However, Blair noted, the City's own revenue plan did not address charging for BOD or COD, just SS and flow.

Exhibit 5 (DK 02266) is a letter from Schlesinger to Blair, dated May 9, 1995. Blair thinks he saw it, and that it is just a request for more time. On page 2, under the heading "Strength-based billing program summary," number 3 states, in part, "draft FY 94 systemwide totals for flow-Q..." When asked whether the use of the word "systemwide" might indicate to Blair that the impending rate change applied to the City as well, not just to the PA's, Blair said the word would not tell him one way or the other, and would only tell him that the City needed the total system information in order to determine what percentage of the total is attributable to the PA's. He thinks it is logical that the City would implement the change for both the PA's and

the City, in part, because by delaying, they put themselves at the disadvantage of charging their own homeowners more than the PA homeowners were being charged. However, Blair has seen it both ways, depending on such factors as the orientation of the City Council and how much pressure is being felt from the business community against raising rates.

Exhibit 6 (DK 02292) is a 06/09/95 response from Blair to Schlesinger. Referencing Blair's 09/1[8]/91 letter, Blair says he is effectively saying that an "approval is not an approval for life," and by that he is referring to the obligation in CFR section 35-228 to implement changes to rate structure as conditions change. Exhibit 7 (SWRCB 0674) is a July 24, 1995 letter from Blair to Richard Enriquez. Blair described this document as addressing a specific grant for a centrifuge at Point Loma. In addressing this issue, he would not have gone back and looked at the City's revenue program. Exhibit 8 (DK 02300), a 7/31/95 letter from Schlesinger to Blair, relates answers to the questions Blair asked in Exhibit 7. As to question 1, Blair thinks the "reverse repurchase" was an internal accounting mechanism to get more money into the City's general fund from the wastewater fund, and Blair recalls that he did not think it should get passed on to the PA's. Regarding question 2, Blair was of the position that the charges for use of rights-of-ways should not be passed on to the PA's. For example, Blair did not think it made sense to charge for the diminished use of a street with a pipe under it, since no use of the street would be lost by the existence of the pipe. In contrast, where a pipe was built above ground and, i.e. a house could not be built there, it would make sense to charge for the lost use. Blair saw the charges as a device to get money from the wastewater to the general fund. His view was that the charges should probably not be done at all, but they certainly should not be passed on to the PA's. He thinks that, ultimately, the City did drop the charges for all users.

Exhibit 9 (COS002563) is a letter from Harold Bailey to William Hanley, cc: Blair and others, dated 02/28/97. The letter states that "As agreed, sampling has continued at specific sites in order to implement Strength Based Billing in Fiscal Year 1998." Blair recalls that his assumption at the time was that strength-based billing was being implemented (not limited to the PA's). It was about this time that he was getting calls from David McKinley as well, and so to him, it seemed like "all signs" indicated that the City was implementing it. Exhibit 10 (MWWD-BH 0222) is a letter to Hedy Griffiths from Blair, dated 9/22/97, regarding approval of a draft revenue program for certain SRF projects. Blair explained that, for the revolving fund loan program, the City would need an approved draft revenue program to get a loan. Since Blair never rescinded the 1991 approval, the City had an approved program in place, and, as previously described, he believed the City was moving forward in implementing strength-based billing. Exhibit 11 (MWWD-BH 0220) is a letter from Griffiths to Blair, dated 10/01/97, "re: Acceptance of Chemical Oxygen Demand (COD) Testing." Blair understood that, in this letter, the City was asking to use COD rather than BOD as the parameter by which to measure organics. In Exhibit 12, a letter from Blair to Griffiths, dated 11/6/97, re: "Revenue program review" (the re: line being simply an internal reference for Blair for his own filing purposes), Blair affirmed that the City could use COD, rather than BOD to calculate sewer rates. Blair acknowledged that his letter does not address the distinction of including organics for the City or PA's, and he said that in his mind he simply assumed the change was system-wide, a view that was reinforced when McKinley called him to tell him that the City was moving forward with implementation.

Exhibit 13 (SWRCB 1530) is the 1996 Revenue Program Guidelines. Blair described the language in these guidelines as "the same language" contained in Exhibit 1 (the

1983 guidelines.) He would still interpret these guidelines as providing that organics need not be measured absent some incremental cost for specifically removing them, and, as with Exhibit 1, he would revise the language to explicitly include the "as appropriate" language. While the language actually used suggests that measuring organics is mandatory, Blair may technically agree that it is, but practically speaking, he would never tell small communities to measure them, and, regardless of the language, states that it would not be necessary to measure organics in a primary-only environment since organics would not be removed there. Practically speaking, if a permit did not have a BOD requirement, and there was no cost for organics removal, there would be no reason for a city to incur the expense.

Of David McKinley, Blair recalls that he received a number of calls from him. Blair's impression of McKinley was that he was looking for any argument to convince Blair that Kelco should not pay more. Among Kelco's arguments were that the City was not incurring a cost for removing organics, and even if it were, Kelco's specific organics could not be removed because they were soluble, and thus not removable through advanced primary treatment capabilities (it would take secondary treatment to remove soluble organics). Blair's point was that regardless of whether Kelco's own organics could be removed, there were permit limits as to the amount that must be removed, so if Kelco's own organics were not, then somebody else's must be as a result of Kelco's discharge. Blair also commented that there are articles to suggest that kelp waste (such as Kelco's) is beneficial to the environment. Nevertheless, Blair said that whether the discharge was good or bad was immaterial.

Exhibit 14 (SWRCB 0425) is a letter from Griffiths to a distribution list with a cc: to Blair, dated 05/22/98, re: "FY 1998 Metropolitan Sewerage System Budget Estimate." The letter discusses the division of costs identified in the PA agreements. Blair said this is not the type of document he would review since he would not be in a position to assess whether or not the numbers were correct. Exhibit 15 (SWRCB 0375), a letter from Griffiths to Blair dated 08/31/98, transmits the executed agreement between the City and PA's. Based on this and other documents, Blair said that all of the information filtering up to him was showing him that things were moving along.

Exhibit 16 (MWWD-BH 10927) is an email from Griffiths to Hanley dated 12/30/98 re: "SWRCB – Ron Blair and Kelco" that, on its face, Blair does not appear to have received. The email references a conversation Griffiths said she "just" had with Blair, in which Blair told Griffiths of some conversations he had with Kelco's McKinley. Blair said that he thinks Griffiths' summary of the conversation was "pretty much correct," and he recalls having this conversation, and probably a number of others, with her. The reference in the email to Blair's commenting that it would be up to the City whether to "amalgamate all costs" is a reference to the issue of whether communities with more than one treatment plant can charge some users more than others. For example, if some users discharge flows down to the treatment center via gravity, while other users require a pump station to pump waste up hill, then the latter scenario would provide a specific justification to charge some users more than others. Charging more on the latter scenario would satisfy a proportionality test, but administratively it can be very expensive to administer. The alternative is to average out all treatment costs such that upstream and downstream users would all pay the same, based on discharge as a percent of the overall system costs, rather than based on actual costs. San Diego uses this latter "amalgamated approach" rather than separating out costs for users of Point Loma, versus North City, versus South Bay. Griffiths' summary reflects that Blair told McKinley that whether the City wants to

amalgamate costs is a choice for the City, but they must implement a uniform policy for all users. Blair does not recall Griffiths telling him in this conversation that the City was still on SS and flow for municipals (as the email states), but acknowledged that, even so, he knew the City was not "on it yet" since this was at the time Kelco was calling him. Nevertheless, he took from his conversation with McKinley that the City was moving to it, and the PA's had just moved to it one year before. He recognized that these things take time, and that citizen involvement could account for some delay. He said that he would not have thought it all that unusual if it even took the City up through 2000 to implement the change, but by 2003, it was unusual.

Regarding the second to last paragraph of Exhibit 16, that "We talked some more about system charges, the acceptance of the PA's. . .," Blair explained that he cautioned the City that whatever was done internally must also be administered to the PA's. Since methodology, cost, and other areas were already covered in the PA agreement, Blair cautioned that if the City were to do anything different, it would be required to get the PA's to sign onto the arrangement as well. Griffiths commented in the email that, "The system as a whole is what has allowed us to avoid secondary treatment." Blair described this comment to likely mean that South Bay and North City were removing organics by this time, and the SWRCB looks at the overall system as a whole. If the City were required to remove 80% of the total organics discharged, if Point Loma were removing less than that but, with South Bay and North City the overall amount of removed organics met that 80%, then the requirements would be met. The State's view of the system as a whole allowed less organics to be removed from Point Loma. Kelco does not use the North City facility since it is downstream from it, but nevertheless Kelco must take into account the benefits it received from the presence of North City, since less is spent at Point Loma as a result of the greater amount of waste treated upstream at North City. Karen Keese, referenced in Exhibit 16, is a consultant that worked with the PA's, and in fact he said she was the one that called him in 1994 and asked him to do the review. He said she was also involved in the stakeholder's group.

Exhibit 17 is a composite exhibit containing two documents, EA 0832 and EA 0833). EA 0833 is an email from Keese to the MWWD (Hanley) re: "Comments Regarding David McKinley." The email summarizes a conversation between Keese and Blair regarding issues raised by McKinley. Blair recalls that, from 1994, he made it clear that once there were costs that could be allocated to organics, the charge would need to be added to the rate structure. Blair described that he was under the impression as of 1994 that the City's revenue program included an organics parameter since, by that time, all the other big cities had secondary plants (and thus charged for organics). He does not recall this conversation with Keese. Blair emphasized that when he wrote the City's approval letter he did so because he was told that the plan had been reviewed and approved. In EA 00832, a document stating at the top, "Response to September 25, 2000 comments by David McKinley. . . Summary of discussion with Ron Blair," there is a heading entitled, "Comment by Ron Blair." The comment references Blair's 1994 field review, and says "During and after that review he informed the City that they must implement the provisions of their approved revenue program and specifically they must determine and implement a charge for BOD. . ." Blair thinks he probably did make the comments contained under the heading. He acknowledges that he thought at the time that the revenue plan did contain an organics requirement, but that (as he later learned), it did not. He thinks that, as of this time, he had not yet looked back at the program. It was not until much later when Doug Sain made a comment about Los Angeles having been given approval for a methodology that San Diego was not, that Blair pulled out San Diego's 1990 program and first realized the plan did not include organics. He never pulled it out sooner because, from the conversation with Keese

earlier, he had the impression that organics were included. He said he "got away with" the misconception for almost 10 years because no one challenged him on it.

Blair said that he was not aware of the stakeholder process that took place in late 2000 and early 2001, either at that time or until Fall 2003, when Kahlie called him and told him he needed to get the group off dead-center. [Note: Blair seems to be mistakenly referring to the later PUAC, not the earlier stakeholder's group. He later corrects this recollection, as described below.] Kahlie's concern was that the City staff did not think that the requirements were actually state and federal requirements. Blair recalls going to talk to the stakeholders group, and what he knew of the group at that time was that they were meeting to discuss implementing the Black & Veatch study. Blair thinks the group may have seen its role as looking for alternatives to the study. It seemed that Kelco/ISP thought that the City was trying to get more money out of them than from the individuals. He does not know when the group got started but knew that Black & Veatch was to finish its work by 2003.

Exhibit 18 (COS 002017) , is an email from Blair to Richard Enriquez, dated 01/31/02, re: Requirements for draft revenue program, and Exhibit 19 (COS 002018), is the response from Enriquez to Blair, dated 02/11/02, "re: Requirements for draft revenue program." Blair believes that, as of the time of this 2002 email, he was under the impression that COD/BOD were understood to be a requirement. Exhibit 18 refers to a project that the City wanted to fund through the SWRCB. The email exchange reflects Blair's attempt to understand whether the project should affect rates. The issue was, if there were additional costs, how would they get passed on to users. Blair said that all questions regarding the SRF program were directed to Enriquez. This particular exchange appears to refer to a loan for the City to build a wet water facility. Specifically, Question #3 in Exhibit 18 is posed by Blair to Enriquez, asking "On what basis are these increased costs passed on to the City's residential, commercial and industrial wastewater dischargers?. . ." Enriquez responds in Exhibit 19 that, "How these costs will be distributed among each class of residential, commercial and industrial users will be determined based by the Sewer Cost of Service study, presently under way." Blair did not know then what was meant by "sewer cost of service study," and thinks that could have been an internal reference. The answer to #3 continues, "These are Metro sewerage treatment costs. Each agency, including the City of San Diego pays their fair share based on metered flow and cumulative samplings which is balanced against the total amount of sewage treated within the system." The reference to "metro" indicated to Blair that it was the City's share of the cost. Blair thinks he probably interpreted the statement about each agency, including the City, paying its fair share, to mean that there was a COD/BOD component. Upon looking at it now, Blair points out the subtle distinction that the statement actually just says that the *City* pays that, but it does not say that the City passes that charge along to its users.

As to whether BOD/COD was required by this point, Blair said that after North City came online, whether BOD was needed was a "no-brainer" since a secondary treatment facility existed that removes organics.

Exhibit 20 (SWRCB 0288) is a letter from Kahlie to Blair, dated 05/22/01, re: "Wastewater Revenue Program Cost Allocation Methodology." Upon looking at this letter, Blair corrected his earlier statement that he had not known about the stakeholder's group until 2003, and he acknowledged that as of this date he knew of it. Blair generally recalls that Kahlie had asked him if he would approve a certain methodology, and Blair said he did not think so, but he told Kahlie to put it in a letter. Blair does not know whether the study referenced in this letter

was the same one that was done in 2003. The letter discusses different methodologies in an attempt to ascertain which methodologies would satisfy proportionality. At the bottom of the first page, Kahlie writes, "As you know, we currently use the functional-design approach in allocating costs to the wastewater parameters for [PA] billing purposes." Blair said that the reference to the City using the functional-design methodologies for the PA's only told him then that the City was looking at ways (studying) how it was billing for flow. Blair reiterated that his mindset until 2003 was that the City was using the same approach for the City and PA's. He said that given that he had this understanding, it would have taken pretty strong, clear language to correct it.

Blair explained that "functional design" meant that, from a functional standpoint, what was a plant designed to remove, and what was it actually removing. At Point Loma, the plant was built to get rid of 80% SS and 58% BOD, and while the main cost actually incurred was for SS removal, and BOD removal did not necessarily cost the City extra, nevertheless, costs were still allocated in a proportional manner. Blair said that charging for the incremental cost of removing BOD over SS would have been ok. He emphasized that his purpose was simply to ensure that there was a rational basis for dividing costs. Under the proposed "STSS" (straight total suspended solids) methodology, where, at Point Loma for example, you would have to remove 86% SS (6% over the permit requirement) to get to 58% BOD, users would only get charged for the incremental 6% needed to meet the organics requirement.

Exhibit 21 (EA 00604) are handwritten notes stating at the top, "Sudhir - Spoke to Blair yesterday (06/07/01)." The note summarizes Blair's "preliminary comments," including that he would not support any full incremental method unless it also applied to the PA's. Blair recalls insisting that the PA's and the City must use the same allocation methodology since the City is not permitted to charge internal users inconsistently with outside users. Regarding McKinley's partial incremental method (the "STSS method"), Blair stated that Kelco had a general methodology that they just continued to tweak ever so slightly to see if they could get it approved. Exhibit 22 (SWRCB 0222), a 07/10/01 letter from Blair to Kahlie re: "Wastewater Revenue Program Cost Allocation Methodology. . ." was a supplement to Blair's June 2001 letter. Blair was told by his own supervisor that he needed to take a more firm stand than he took in the previous letter. Blair wrote on page 1: "The City's current user charge system. This method allocates costs by functional design and percentage of TSS and BOD removal at the various treatment plants. This method results in a user charge system that allocates all users in the City and [PA's] the same unit cost for wastewater treatment services. . ." Blair confirmed that this excerpt reflected his thinking that the City was then using COD/BOD. On page 2 Blair's letter continues, "The City's existing method of allocating costs, the functional design approach, has been previously reviewed and approved by this office." He goes on to say that the PA's use it and that the City is "contractually required to use this method for determining the" PA's costs. He continues that, before a change would be approved to the "current wastewater user charge system," certain issues would need to be addressed. [This last statement is further evidence of Blair's mistaken impression.] Blair's intention in writing this letter was that he never wanted to close the door to the City coming up with some other equitable way to allocate costs, provided the City received the PA's sign-off on it. Blair's response was partially driven by the input he was getting from Kahlie that City staff did not think the STSS method was equitable, and that the City was looking for support from the State. Blair thought they laid the allocation issue to rest in 2001 but said that, "apparently in 2003 it was alive and well."

Blair recalls that when Kahlie called him in the Fall of 2003 and told him that the City was still not using BOD/COD, and that it looked like without Blair's input it would not be, Blair recalls being surprised. Blair cannot say whether, as of 2001, he knew they were still working on implementing the COSS, or thought they had resolved it by then.

The requirement in the SRF to adopt an approved revenue plan is mandatory (it states that the Agency "shall adopt"). As for the State's ability to withhold the last percentage of loan disbursement until an approved plan was implemented, the practice evolved such that the earlier loan principal would be disbursed completely, and the amount that would theoretically be held back would be the last 5% of the sum total of all outstanding loans (rather than withholding the last 5% of a loan for any one individual project).

Exhibit 23 (no bates) is a letter from Blair to Uberuaga, dated 11/26/03. Blair said he wrote this letter when Kahlie called and told him that BOD/COD was never adopted by the City. The letter stated, "Please submit a copy of the City ordinance (or resolution) adopting the wastewater rate system that was previously approved. . . Charges must be based on each user's (or user group's) proportionate contribution to total flow, BOD (or COD) and TSS loadings." In Blair's mind, once the process was used by the PA's, the City also needed to adopt the new rate structure, and probably it needed to adopt the same rate structure used by the PA's, since, once the PA agreement was signed, it would have been "tough to renegotiate."

When Kahlie told Blair that someone in either the City Attorney's Office or someone in the "upper echelon" said that the City would wait to implement a compliant structure until the State "bugged" the City to do it, Blair looked in his file for a letter to the City requiring implementation of a compliant rate structure for internal users by a specific date. Blair was surprised not to find such a letter, so he drafted Exhibit 23, in an attempt not to point a finger at City staff, or to "sell out" Kahlie. Even as of the time he wrote this letter, Blair said he was still operating under the assumption that the organics requirement was contained in the City's 1991 Revenue Program, but still, he did not look. Nevertheless, Blair said that (1) he asked the City to incorporate organics in 1994, and (2) there were changed conditions when the City's secondary plants came online that necessitated inclusion of the organics parameter. Blair said at that time he should have asked for a new revenue plan, but he did not. The PA agreements set the standard for what the City had to have (since they needed to be uniform). Blair thinks he probably gave Kahlie some form of heads-up about the letter he was sending to the City.

Exhibit 24 (COS 003269) is a letter from Loveland to Blair, dated 01/08/04, re: "Your letter of November 26, 2003." The letter documented the City's "past and ongoing efforts to achieve full compliance with the user charge requirements of the Clean Water Grant" and SRF programs. Blair said that it was with this letter (if not before) when he "dug up" the 1991 Revenue Plan (he does not recall it being attached to the letter, though it is referenced as an attachment). To Blair, the issue of whether the City was using BOD/COD was long resolved in his mind at this time. Regarding the Black & Veatch study, he does not know whether the one finished in 2003 was the same as the one started in 2000, but he said it is a study that can normally be done in a year or less. He said he got the feeling from the letter that the City was using a "device" known as "studying something to death," in that if you study an issue long enough you will never have to do anything about it.

Blair said that, as far as he knew, the State never penalized a city for not complying with the guidelines, but he added that they "once threatened L.A.," and that they do

have a right to impose penalties. The State can call the State loans immediately. What would happen with the grants was less clear than the loans. Blair said that there is a C.F.R. section that lists all of the various penalties, up to and including full repayment of the grants and rendering a community ineligible to receive any federal assistance (including welfare, etc.). Typically, in instances where Blair would encounter noncompliance because people lacked knowledge of the requirements, he would educate them of requirements and also refer to the CFR codification of the penalties. With L.A., the EPA threatened to disallow 3% of the grants to date and to bring suit against the county that was out of compliance, so the county complied. With San Diego's lack of compliance, Blair could have issued anything from a slap on the wrist up to full repayment and prohibition on recovering any future federal money. However, he said that he would have had to declare noncompliance and he never really did that.

Blair also recalled that, at the end of his field visit, he had an exit interview in 1994 with a senior city staff member, whose name he does not recall. Afterwards, he got a call from either the City Attorney or someone from the City Attorney's Office (he was not sure), and that person asked Blair whether Blair would say the City was not in compliance, because if so, the City would need to make a disclosure. Blair's response was that it seemed like "they were looking to fix the problem." From that time on, he was always hopeful the City would comply. Specifically, he was asked, "Are we in noncompliance?" Blair responded, "No." At that time, he was not saying they were in noncompliance or in violation of their grants. Blair said they were making changes. Blair does not recall whether the attorney called because he got the 1994 letter, or because he knew the letter was coming. He believes the call was in the Fall of 1994. This disclosure issue never came up again from anyone in the City Attorney's Office. No one talked to him about disclosures. Had they, Blair would have had to refer them to someone else because disclosures "seem like a moving target" to him. He could, however, address whether there was a non-compliance situation.

He said, in retrospect, that it was clear from the requirements that the City needed to change the rate structure, but that there was no correspondence to that effect from the SWRCB until later. Had he known in 1994 that there was no organics component in the approved Revenue Plan, he would have requested another one. In terms of the amount of time it took the City to get into compliance, Blair did not affirm that it was "unreasonable or excessive," but did say that he could not think of another situation that took so long. That said, he could think of situations where it took several years.

Exhibit 25 (SWRCB 0206) is an email from Kahlie to Blair, dated 02/17/04, re: "Cost Allocation Methodology." The email discusses that cost allocation methodology is a "core" concern of Kelco's. Blair classified this as a case of people only hearing what they want to hear. Blair was reluctant to rule out any one method in favor of another, but Kelco's STSS method had specific, unapprovable items. He could not state whether, "in general," he would approve an incremental method because he would have to see it first. Exhibit 26 (COS 002766-67) is a fax from Kahlie to Hanley, dated 02/26/04, attaching a letter from Blair to Kahlie dated the same. Blair recalls that, after meeting with the PUAC, he had a one-on-one conversation with McKinley in which Blair said that he would not approve the methods he had seen to date, but there could be some method with the necessary elements that may be approvable. An incremental cost methodology could mean many different things, and Blair refused to say there was no incremental method he would approve. As the methodology debates continued, Blair

told the parties that they had to have something adopted by June, but after adoption, they could then continue to do studies.

Exhibit 27 (COS 003267) is a 3/24/04 fax from Kahlie to Webber transmitting a 03/17/04 letter from Blair to Uberuaga. At this point, Blair had been given the Black & Veatch study, and this letter to the City was designed by Blair "to keep fire under their feet." He characterized it as him reclarifying for the City what they were doing and what remained to be done. He had the impression that someone was just encouraging more studies to delay implementation, and he was telling them to get it done by 06/30/04.

Exhibit 28 (DK 03919) is an email from Kahlie to Blair, dated 04/06/04. The email refers to a conversation Blair had with Sain, in which Blair is emphasizing that the City must comply with the July 1 deadline for compliance. Blair recalls that Kahlie had called him to say that Sain wanted more studies, and Kahlie wanted Blair not to get sidetracked and sucked into more studies. Sain was proposing a "cost causative" approach, in which Sain was lobbying to have only the extra 6% beyond the permit requirements attributed to organics, and that the first 80% would be a "free ride" for organics. The City wanted to split the 86% up among organics. Ultimately the City did not go with the proposed cost-causative approach since that would require more studies, but Blair was saying he would not rule them out completely.

Blair's primary contacts in the City were Hedy Griffiths, in connection with loan approval, and Kahlie, in connection with reviews of the cost of service studies. When Kahlie called him, the substance was that the change should have been done and that they had been trying to get it implemented, but now he needed Blair's help. In essence, Kahlie told Blair that if the City did not have something in their files giving them a deadline of what they needed to do and by when, they would not do it. He recalls that direction coming not from an elected official, but from the City Attorney's Office (as Kahlie communicated the situation to him). Blair also had contact with Karyn Keese, the consultant (as described above, who communicated that the PA's were not charged BOD/COD). He never had any discussions with her that "someone was in someone else's pocket." From his contact with Sudhir at Black & Veatch, Blair thought Sudhir was trying to defend the study more than anything else. Sudhir never said the City was "sitting on the study."

In terms of routine time issues, a normal rate study is ordered in the Spring and done by the Fall. Much of the study involves work at the outset to decipher where sewage is coming from, etc. Once that information is available, the studies should move "pretty quick." Blair also said that the regulations require revisiting compliance every 2 years for the life of the loan.

In closing, in response to whether Blair ever had the impression that Kelco/ISP was offering him anything, he did not. He believed that Kelco believed in their arguments. He does not recall whether any councilmember had any ties to Kelco.

Follow-up Phone Conversation with Blair: 09/30/05

On September 30, 2005, we had a short phone call with Blair to follow up on the issue of rate stabilization funds. The issue we posed was whether the funds violate the SRF covenants, since sewer charges exceed actual costs, and the surplus is put in these funds for certain situations that could arise in the future. Rate stabilization funds have not concerned

Blair, since: (1) enough revenue is generated to cover operation and maintenance, and (2) the charge is on a proportionate basis so everyone pays their fair share.

However, Blair observed that one question that never came up in the past: In the time that there was no organics charge in the City, residents were arguably paying out of proportion to industry, and therefore the surplus from the funds should go back to that specific user group that was being overcharged, rather the funds being returned to revenue at large. In short, the excess money has to go back to the group that paid it. If there is excess revenue it must be paid equally across the board.

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